A Conceptual Review of the Challenges of Effective Tax Collection from the Informal Sector in Kano, Nigeria

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Abstract

The informal sector is often referred to as unregulated financial undertakings and poses a serious challenge to government in relation to tax revenue collection. The main issue of concern is why a wide gap exists between the actual tax collections from the informal sector and the potential tax that should be collected. Thus, the main aim of this study is to identify and examine some of the challenges militating against effective tax collection from the informal sector in Kano State, Nigeria. The paper is literature based, as such, it critically examines current literature on tax collection. It was discovered that issues such as reliance on cash based transactions, absence of required records and weak tax laws are some of the challenges preventing effective tax collection from the informal sector. It is therefore recommended that tax collection from the informal sector could be enhanced when government educates the informal operators, strengthens tax laws, emphasize on adequate records keeping and simplify the formalization procedures.

Keywords: Tax collection, revenue, informal sector, Nigeria

1.0 Introduction

The importance and pattern of tax governance in the informal sector became increasingly recognized and accepted as a topic in accounting research in the 1950s and 1960s with initial interest in this sector beginning with the third world framework by Hart in 1971. However, it was not until 1972 that the International Labour Organization (ILO) decided to find an accurate academic meaning and gave it the name "informal sector" (ILO, 1972). The ILO described the informal economy as characterized by family ownership, reliance on local contents or resources; ease of entry; small size of operations; adaptive technology; labour-intensive input and competitive but unregulated markets. In view of this, many arguments have been advanced in relation to taxing the informal sector. Social critics are of the view that taxing the informal sector will result in high, low or even negative yield with administrative costs being higher than the expected revenue, thereby negating the economic principle of tax collection (Kleen, 2012).

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The informal sector or economy is generally seen as a key component of most economies of the developing sub – Saharan Africa (ILO, 1972). It is believed that this sector contributes about 25% to 65% of gross domestic product (GDP) and accounts for 30% to 90% of employment in developing countries (Celine, 2017). In Nigeria, the informal sector is seen as the total economic activity that takes place outside state regulation and which is neither captured by the tax system nor represented in the country's GDP. It is an extremely large and diverse portion of economic activities within the country, covering state, local and federal levels. One of the pronounced characteristics of the informal sector is absence of modern accounting framework hence its economic activities are normally under or completely not reported in social measurements such as the GDP.

In general, the informal sector in Nigeria operates with some degree of freedom. This is because the sector is traditionally considered as consisting of economic activities that are hidden and unregulated by government but governed by customs and personal ties (Godfrey, 2011). Therefore, taxing the informal sector occupies a pivotal place in the domain of many sub-Saharan countries including Nigeria (Okoye, Akenbor & Obara, 2012). In addition, Calbreath (2016), considers the informal sector as that portion of an economy that operates informally (without registration) and hence not monitored by government regulatory enforcement. This is because the sector is made up primarily of self-employed individuals and a large number of people operating micro-businesses as their main source of economic activities (Celine, 2017). The income generated in these types of businesses is not officially captured in the country's tax records. However, businesses in the informal sector operate using the facilities provided by the government from revenue realized through taxation. Similarly, the persistent growth of informal activities, the absence of regulation and ineffective tax collection from the informal sector results in substantial revenue loss to states in Nigeria.

Furthermore, other scholars also argue that the informal sector has unstable businesses and typically earn less income, have no access to basic social protections and services rights and therefore lack the potentials for growth (Mackenzie& Sakho, 2010). Thus, there is a need to study the taxation of the informal sector in developing economies such as Nigeria to find out whether taxing the informal sector will assist in tackling the much needed revenue generation issues of the government (Wambai & Hanga, 2013). The rationale behind taxing the informal sector is bordered on the need to increase revenue generation drive, enhance good public governance, accountability, growth and to generate employment (NTP, 2012). In other words, the surest way to grow revenue is to grow taxes.

Table 1 shows the report of tax collection from the informal sector obtained from the Kano State Internal Revenue Services (KSIRS). The report shows that there is a very wide margin of about two billion Naira annually of uncollected tax from the informal sector. For instance, in 2016 the difference was three billion Naira between the budgeted and actual tax collections from the informal sector. Thus, the size of the gap in terms of percentage to the budgeted collections was 72%. In other words, the amount collected was only 28% of the budgeted figure as reported. Similarly, the size of the tax gap was much higher in 2017 when it was 86%, which means only 14% of the budget was actually collected. However, there was an improvement in 2018 when 40% of the budget was collected reducing the tax gap to 60%. Overall, only 25% of the budget was actually collected, leaving a wide gap of 75% of uncollected tax from the informal sector. In view of the foregoing, it could be concluded that government is losing a substantial amount of tax from the informal sector which could be utilized in fixing the critical infrastructural deficit of Kano State and many other states in Nigeria.

Table 1

Informal Sector Tax Collection

S/N	Year	Budgeted	Collection	% Of Tax Gap
1	2014		N213,445,403.09	---
2	2015	N2,200,000,000.00		---
3	2016	N4,200,000,000.00	N1,176,521,144.10	72
4	2017	N3,150,000.000.00	N441,220,431.20	86
5	2018	N4,110,000,000.00	N1,648,964,653.26	60
	Total	**N13,660,000,000.00**	**N3,480,151,631.65**	

Hence, the main issue of concern is the wide gap existing between the actual revenue generation from taxing the informal sector and the revenue that should be generated (see table 1). The revenue generation capacity of the states in Nigeria will increase if they can identify and design policies to build the capacity of the informal sector operators and provide avenues that will bring them into the tax net. Kano State is selected in this paper because it is the most populated and housed the highest number of micro enterprises in the informal sector in the country (MEDAN/NBS, 2013).

This objective of this paper is to theoretically analyze the relationship between effective tax collection from the informal sector and revenue generation. Therefore, it is expected that effective informal sector taxation will bridge the existing revenue gap in Nigeria. The paper is divided into the following sections and subsections: introduction, the concept of informal sector, the informal sector in Nigeria, issues on tax collection from the informal sector, informal sector and revenue generation, challenges of tax collection, conclusion and recommendations.

2.0 Literature Review

2.1 The Concept of Informal Sector

Since the introduction of informal sector as a concept in Africa, the idea does not lend itself to a comprehensive and a universally accepted definition. Several attempts by different scholars to define the concept have resulted in different definitions being proposed. Also, most of the definitions were based on the availability of data and individual understanding of the concept of informality. For instance, Friedrich and Dominik (2000) state that, efforts to quantify the informal economy also known as shadow economy were first confronted with the problem of defining it'. There are several definitions of the concept in the existing literature. For instance, the Kenya Mission Report of the International Labour Organization (1972) defines informality as a "way of doing things characterized by ease of entry; small scale operations; reliance on indigenous resources; labour intensive and adaptive technology; family ownership; skills acquired outside of the formal sector, unregulated and competitive markets."

According to Feige (1989), "all monetary undertakings that are officially computed in the GDP from unregistered businesses are known as the informal sector. Also, Smith (1994) believed the informal sector is "Market-based production of merchandise and ventures, whether legitimate or unlawful, that could not be identified in the official assessments of the GDP". Hart (1973) defined the informal sector as all "unregulated financial undertakings or exercises". However, Farrell et al. (2000) argued that there are only two ways to deal with the problem of defining the informal sector which are "definitional and behavioural".

Thus, the definitional approach sees the 'Informal sector as comprising of all monetary undertakings which are unrecorded in the official measurements of the GDP (Farrell et al., 2000). However, the behavioural approach sees the informal sector from the perspective of established legal, administrative, and institutional structure. This implies that this approach focuses on the legality of an undertaking.

Overall, Chen et al (1999), confirms that an international definition of the informal economy adopted in 1993 includes persons working in small unregistered enterprises, informal employees and employers as well as self-employed individuals who work in family businesses or work on their own. This definition concurs with the one given by ILO in 1993 as cited in Brunilda and Galantina (2014) which states that "Informal economy is widely characterized as consisting of units involved in production of goods and services with main objective of generating employment and revenues for people involved in it". This means that the informal sector is simply a composition of households with marked production. However, full statistical data on the informal sector business remains a major constraint exceedingly due to its diversity and extent of activities.

Furthermore, the informal economy also referred to as the informal sector is, in the opinion of Jutting and Laiglesia (2009), a sector that records massive share of income, businesses and yield in both low and high pay countries. This sector provides employments to more than two billion individuals globally (Celine, 2017). Previous studies indicated that the informal sector began around the mid-1970s in Africa. From that time till date, the sector has generated considerable amount of interest among scholars and researchers around the world. As disclosed by 'WIEGO' an organization of women in informal employment globaly, the idea of the informal sector came under serious discussion since it came into limelight in Africa in the mid-1970s". Sethuraman (1981) observes that the informal sector began from the International Labour Organization's (ILO) study of Ghana and Kenya in the early 1970s. As observed by Sethuraman (1981) the main issue discussed at that time was not unemployment but rather the endless number of working poor trying to deliver merchandise and operate enterprises without their effort being acknowledged. However, the general consensus is that the informal sector came into universal usage consequent upon the ILO's Kenyan mission in 1972.

Similarly, previous studies also found that the informal sector includes the perpetration of illegal businesses that are largely untaxed (Patrick, 2011; Tutik, 2014). These businesses include, among others, drug dealings, gambling and prostitution. These businesses pose serious challenges to government because offenders are prosecuted after incurring higher litigation costs without commensurate revenue in form of taxes. The absence of relevant tax laws and ethical consideration make it difficult for government to collect taxes from them.

Although the informal economy is dominant in Africa and to a great extent more predominant in less developed countries, the sector is also equally found in developed countries. Tanzi (1982) and Portes, Manual and Benton (1989) argue that the informal sector in numerous industrialized countries expanded amidst the economic slowdown of 1980s and keeps on growing till today. These authors specifically noted the sweet shops which flourish in New York as typical example of a developed country informal sector outfit.

2.1.1 The Informal Sector in Nigeria

The informal sector in Nigeria is very large and heterogeneous and is said to represent about 65-70 percent of the country's economic activities (NBS, 2013). The scope of informal sector operations in the country includes general trading; spare parts; sale of domestic animals; construction works; credit offices; hair dressing; blacksmithing; transportation; agro-allied business, refrigeration, mechanical and electrical work, dressmaking, services footwear, carpentry, barbing salon, laundry services and many others.

Furthermore, informal sector enterprises are commonly low wage, small time organizations, with independently employed and self-administered individuals working outside the government administrative rules and do not pay any tax. The occurrence of Nigeria's huge informal sector has been attributed to the difficulties inherent in entry into the formal sector. For instance, the costs of organizational enlistment, stringent registration procedures, lack of working capital are some of the factors compelling businesses in Nigeria to operate informally. Fundamentally, as a result of its sheer size, it is very hard to have dependable information on the informal sector enrolment and activities.

However, in a survey jointly conducted by NBS and SMEDAN it was found that Nigeria accommodates 36,994,578.00 micro enterprises in different sectors of the economy such as manufacturing, construction, agriculture, transportation, information, communication, education, entertainment and recreation (NBS/SMEDAN, 2013). In an ideal circumstance, public administration and services should be financed by tax collected from both the formal and informal sectors. Unfortunately, the informal sector operators do not have access to capital or social protection and their development is usually constrained and therefore little or no tax is collected from them. However, with the right kind of administrative law, good enlightenment campaign, legitimate organization and a friendly interface, it is hoped that Nigerian government can take advantage of the size of informal businesses and the abundance of taxes likely to be collected from them.

2.2 Issues on Tax Collection from the Informal Sector

Universally, the function of government is all-encompassing and it is charged with providing some fundamental services to the citizens. These services include the provision of Schools, Hospitals, Roads, Railway lines, Airports, Seaports, general defense and protection of lives and properties of the citizens from all forms of aggressions. By and large, government performs social, political and financial functions in order to boost social and monetary welfare of its citizens. However, in order to provide these services, it requires a lot of resources in form of income taxes and other sources of revenue notably charges, rates, licenses, rents and ventures. The more these tax revenues are collected, the more government will be able to perform its duties. It is important to note that, effective and efficient tax collection greatly influences government performance. According to Adesoji and Chike (2013), revenue generation is the heart and pathway to modern development. Using descriptive statistics, the study found positive relationship existing between taxation, revenue generation and infrastructural development.

Similarly, Oseni (2013) examines the effect of internally generated revenue (IGR) as a panacea for development and concluded that states that rely on statutory allocation generate low proportion of IGR. In addition, Edogbanya and Sule (2013) evaluate the relationship between total revenue generation and development and using simple regression concluded that there is significant relationship between tax collection and government's effort for development. In a similar survey, Adesoji and Chike (2013) assess the effect of IGR on infrastructural development through the application of inferential statistics. They found that there is a strong link between IGR and infrastructural development. These studies confirm the position of this paper that without sufficient IGR, the states in the Nigerian federation will not be able to achieve meaningful development.

Furthermore, section 162 (10) of the constitution of the Federal Government of Nigeria (1999) conceptually defines tax revenue as “any income that accrues to or is derived by the federal government from various sources and includes any receipt however described, arising from the operation of law; any return; however described, arising from or in respect of any property held by the government of the federation; and any return by way of interest on loans and dividends in respect of shares or interest held by the government of the federation in any company or statutory body”. In other words, revenue could be defined as total money or income received from various sources. This means public revenue can be categorized into two major classes: tax revenue and non-tax revenues as conceptualized by (Edogbanya and Sule, 2013). Similarly, Adesoji and Chike (2013) opined that revenue in Nigeria is principally derived from tax collection from many other sources including the informal sector.

2.2.1 Informal Sector and Revenue Generation

Taxes are important and most reliable source of public revenue. Taxes are compulsory payments to the state by corporate bodies, individuals and institutions without expecting direct benefit or return by the state. Therefore, taxes provide governments with definite source of revenue to enable execution of its projects (Udoh et al, 2008, Asimiyu et al, 2014). In general, taxes are collected by government to generate sufficient revenue to enable it provide public welfare services that have common benefits to all citizens. Eugine and Abigail (2016) assert that tax is a reliable and sustainable source of revenue for government and a tool for fiscal policy and macro-economic management.

Similarly, Adesoji and Chike (2013) opined that IGR is revenue that is generated from the state’s internal sources particularly taxes. Therefore, revenue from taxation has been described as an important source of revenue to the government all over the world. Previous studies, such as that of Muhammad and Adeel (2011), used panel data to investigate the determinants of tax revenue in India and found that the country generates most of its revenue from direct taxes. Also, Azka (2014) using time series data empirically investigated the factors affecting tax collection in Pakistan but found that real per capita income boost tax revenue. Furthermore, government collect tax through direct and indirect methods which are referred to as direct and indirect taxes. Direct taxes include company income tax; personal income tax; capital gains tax; road taxes; land use charges; fees; levies and property tax. On the other hand, indirect taxes include custom duties; excise duties and value added tax (VAT).

However, in the Nigerian context, tax revenue contributes a small part of the total government revenue. Income from crude oil accounts for more than 80% of the total federal revenue while the balance of 20% comes from the non-oil sectors which include tax revenue (Otu and Theophilus, 2013). Eugine and Abigail (2016) found that, although direct and indirect taxes could be expanded, their impact is limited because of the widespread informal sector activities in the country. In addition, taxing the informal sector to earn additional income poses many problems to government (Njeru, 2012). This paper uses related and relevant literature to discuss tax collection from the informal sector and its challenges.

3.0 Challenges of Tax Collection from the Informal Sector

Quite a number of challenges are encountered by tax administrators in their attempt to effectively collect tax from the informal sector in Nigeria. Previous studies have discovered that taxing the informal sector has not been successful due to capacity constraints, equity and politics (Joshi & Ayee, 2009).

The informal sector in Nigeria conducts their business activities on cash and carry basis. In other words, most of the transactions are cash based transactions. These businesses often do not acknowledge cheques along these lines empowering them to cover their turnover and assessable profits. With the specific aim of avoiding taxes, these organizations control their sales figures and profit for assessment and hide all information relating to their activities (ILO, 1972). Similarly, most informal sector businesses in Nigeria do not keep up to date accounting records. Consequently, it becomes very difficult to ascertain their income or turnover for the purpose of assessing their tax liability (Genevieve, 2016). This is due to complete absence of accounting records which is a very serious challenge because without records the tax authority will find it difficult to assess the business.

Furthermore, the tax assessment instrument and procedures are often cumbersome. This is one of the boundaries prohibiting micro businesses to cross over from informal setting to the formal segment where they can get easy access to capital. In other words, the tax structure in many states in Nigeria is complex ignoring the informal sector and therefore makes crossover between sectors difficult (Genevieve, 2016). Similarly, states internal revenue services in Nigeria suffer from Capacity constraints in terms of availability of trained tax collectors that can adequately cover the large untaxed informal sector (Ekpo and Umoh (2014). In addition, Weak tax laws is aanother challenge. Tax authorities do not have the ability to recognize, review or even legitimately enforce the relevant tax laws against tax defaulters which is a very serious concern in relation to deterrence theory. Similarly, these tax laws are also weak and tax authorities find them difficult to interpret and enforce (Musa (2016).

Similarly, many entrepreneurs in this sector are unwilling to pay taxes imposed on them because they have no faith in the administration presently in operation. They seem disillusioned by the absence of improvement in infrastructure and public goods in the country, as such, they stay in the informal sector to avoid formal tax payment (Oriaka and Osenwenge (2013). In a recent study, Musa (2012) observes that it is difficult to differentiate between the actual capitals of the business; the profits earned and even the owner's private money so that it is distinguishable for tax purposes. Non-separation of personal wealth from business capital results in the inability to ascertain business profits which makes it almost impossible to correctly assess the actual tax payable by the informal business. However, developing countries including Nigeria do not give due consideration to the important role the informal sector plays in the economic development of their countries. Many policies initiated by government seem not to be working in support of the informal sector so as to stimulate productivity and encourage development aimed at formalizing their operations to join the formal economy. In other words, there is absolute Lack of support from government to informal sector businesses in order to enhance tax collection.

Furthermore, effective tax collection from the informal sector is seen as a function of adequate information (Genevieve, 2016). However, considering the nature of operation of the informal sector, getting information is certainly a difficult task. With the specific aim of evading taxes informal sector businesses hide all information relating to their activities (Olusola, 2014). Another challenge is Lack of awareness of tax obligation among the informal sector. Awareness campaign involves tax education to enlighten the informal sector operators on their civic responsibilities. It also involves a number of campaign strategies to make the informal sector aware of the importance of paying tax. It is important to note that awareness in relation to tax payment is very poor in Nigeria. Previous studies have indicated that awareness is an important determinant of tax collection and its absence is a serious challenge that affects tax collection from the informal sector negatively (Oriakhi & Osenwenge, 2013). In Nigeria, Political Considerations play an influential role in the way government operates. In order to score political goal cheaply and gain popularity, the application of tax laws becomes selective especially in the informal sector because of its size. This affects the tax collection effort of tax authorities negatively. In addition, majority of the informal sector operators and businesses have very low income (Joshi & Ayee, 2009). This means that it will be difficult to assess their ability to pay tax which is a very important principle of taxation. Also, in Nigeria, there are difficult and Stringent Registration Procedures which make switch over from the informal to the formal sector extremely difficult (Okeye, Akenbor & Obara, 2012). Finally, high cost of registering a micro and small business in order to formalize operation is high. This often make informal sector businesses to prefer staying within the informal setting (Okeye, Akenbor & Obara, 2012) rather than formalizing their operations.

Table 2 shows the summary of the issue or challenges preventing government from effectively collecting taxes from the informal sector.

Table 2

Challenges of Effective Tax Collection from Informal Sector

S/N	Challenge	Source
1	Cash Based Transactions	ILO (1972)
2	Absence of Accounting Records	Genevieve, (2016)
3	Tax Assessment Instrument	Genevieve, (2016)
4	Capacity Constraints	Ekpo and Umoh (2014)
5	Weak Tax Laws	Musa (2016)
6	Lack of Incentives	Oriaka and Osenwenge (2013)
7	Non-Separation of Personal Wealth	Musa, (2016).
8	Lack of Support from Government	Olusola (2011)
9	Lack of Adequate Information	Genevieve, (2016), Olusola, (2014)
10	Lack of Awareness	Oriaka and Osenwenge (2013)
11	Political Considerations	Ekpo and Umoh (2014)
12	Equity	Joshi and Ayee (2009)
13	Stringent Registration Procedures	Okeye, Akenbor and Obara (2012)
14	High Cost of Registration	Okeye, Akenbor and Obara (2012)

4.0 Recommendation and Conclusion

The informal sector with its unique features in terms of economic activities carried out is a major employer of labour in Nigeria. Most importantly, it contributes immensely to employment and growth in the GDP of many sub-Saharan African countries. However, it is often described as consisting of unregulated and hidden financial undertakings comprising of manufacturing; mining; transportation; construction; trading and education. Furthermore, there is dire need for government to explore the potentials of this sector especially with regards to tax collection. However, the informal sector poses serious challenges to governments when it comes to tax collection to generate revenue. From the review, it has been discovered that these challenges, notably dealing in cash based transactions; absence of records; lack of awareness; inadequate information; lack of government support and weak tax laws have far reaching implications which, if not carefully handled, could lead to zero tax collection from the sector. Similarly, these challenges are likely to result in increase in informal sector activities thereby threatening formal sector operations. Therefore, it is expected that tackling these challenges head on will improve tax collection from the informal sector in Nigeria, reduce tax evasion and improve the sector's contribution to the Nigerian economy. Thus, it is concluded that the challenges militating against effective tax collection from the informal sector in Nigeria have negative consequences on the Nigerian economy and pose serious threat to the growth of the formal sector.

Based on the above discoveries it is recommended that, the Nigerian tax laws should be reviewed and simplified in order to strengthen their applicability and enforcement in relation to the informal sector in Nigeria. Also, the tax assessment and collection machinery should be made more effective to accommodate the sector in order to improve tax collection. Furthermore, an empirical study in this context is recommended to unearth more of the practical challenges of tax collection from the informal sector and proffer recommendations required to improve tax collections from the sector and enhance the formalization of the informal sector.

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